BEFORE THE ARIZONA CORPORATION COMMISSION

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CHAIRMAN
JIM IRVIN
COMMISSIONER
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COMMISSIONER

IN THE MATTER OF THE COMPETITION IN THE PROVISIONS OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. U-0000-94-165

APPLICATION FOR REHEARING BY CITIZENS UTILITIES COMPANY

Pursuant to A.R.S. §40-253 and A.A.C. R14-3-111, Citizens Utilities Company ("Citizens" or "Company") hereby submits to the Arizona Corporation Commission ("Commission") this Application for Rehearing of Decision No. 59943 (December 26, 1996) in the above-captioned docket. Citizens respectfully urges the Commission to correct and clarify Decision No. 59943 in accordance with the following discussion, points, and authorities:

I. INTRODUCTION

Since the outset of the proceedings that culminated with the rules adopted in Decision No. 59943, Citizens has supported the Commission's decision to move the electric utility industry away from a system of regulated monopolies and toward a more competitive marketplace. However, Citizens has consistently voiced its concern that the proposed rules, which are in many key respects identical to the rules adopted pursuant to Decision No. 59943, mistakenly established goals and timetables for the introduction of competition while leaving unresolved a host of critical legal, financial and operational matters. The Commission's failure to remedy these deficiencies in the rules ultimately adopted is clear error and has resulted in the Commission promulgating rules that are little more than a work in progress which it intends will govern a fundamental structural change in the electric utility industry. As outlined below, the Commission's decision to leave for another day many of the difficult issues that will affect all utilities and electric service providers in Arizona undermines

the validity of the Commission's rules.

Moreover, the rules contain specific procedural and substantive errors that require the Commission to grant this Application for Rehearing. As detailed below, the rules adopted pursuant to Decision No. 59943 are procedurally invalid because they were promulgated in violation of provisions of the Arizona Administrative Procedure Act. In addition, the Commission's failure to address important issues renders the rules impermissibly vague in violation of due process. Further, the Commission erroneously failed to address basic issues concerning stranded cost recovery, and improperly dismissed these matters as "premature." The Commission also failed to adequately ensure that revenues from collateral services are not improperly used to offset stranded costs. Finally, the Commission erroneously failed to adopt several revisions to the proposed rules necessary to maintain a "level playing field" between Affected Utilities and electric service providers not subject to the Commission's jurisdiction.

The Commission should grant rehearing of Decision No. 59943 to address these issues and to revise the rules so that they may better guide the transition within the electric utility industry in the manner intended by the Commission. Absent revisions to the rules consistent with this Application for Rehearing, the rules' procedural and substantive errors may undermine the very changes the Commission seeks to bring about.

II. THE RULES ARE PROCEDURALLY INVALID BECAUSE THE COMMISSION ERRED BY FAILING TO PROMULGATE THE RULES IN ACCORDANCE WITH THE REQUIREMENTS OF THE ARIZONA ADMINISTRATIVE PROCEDURE ACT

The rules adopted by Decision No. 59943 are invalid because they were not promulgated pursuant to the rulemaking procedures mandated by statute. The Arizona Administrative Procedure Act, A.R.S. § 41-1001, *et seq.* ("APA"), contains detailed procedures designed to ensure that regulations promulgated by administrative agencies are the result of a measured and deliberative process in which all interested parties are provided the opportunity to participate and the Commission is able to fully and fairly consider all parties' views. The Commission's failure to adhere to these requirements renders the rules

void and of no effect. A.R.S. § 41-1030(A) clearly states that "[a] rule is invalid unless adopted and approved in substantial compliance with [provisions of the APA]." *See, e.g., Cochise County v. Ariz. Health Care Cost Containment System,* 170 Ariz. 43, 445, 825 P.2d 968, 969 (Ariz. App. 1991) ("[i]n order for a rule to be effective, it must be enacted in accordance with the provisions of the APA").

A. The Commission failed to submit the rules for Attorney General review

The rules adopted by Decision No. 59943 are invalid because the Commission failed to comply with the statutory requirement that rules be reviewed by the Attorney General prior to their submission to the Secretary of State. In its order, the Commission directed its Utilities Division to "immediately forward the new Rules . . . to the Secretary of State." Decision No. 59943 at 4. The Commission's failure to comply with the directive that rules first be reviewed by the Attorney General violates the procedural requirements of the APA and invalidates the rules.

The requirement that the rules be reviewed by the Attorney General is indisputable. A.R.S. § 41-1044 directs the Attorney General to review all rules that are exempt from review and approval by the Governor's Regulatory Review Counsel pursuant to A.R.S. § 41-1057, which includes rules promulgated by the Commission.[1] Specifically, A.R.S. § 41-1044 (B) provides:

> Rules that are exempt pursuant to § 41-1057 shall not be filed with the secretary of state unless the attorney general approves the adopted rule as:
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> 1. To form.
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> 2. Clear, concise and understandable.
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> 3. Within the power of the agency to adopt and within the enacted legislative standards.
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> 4. Adopted in compliance with the appropriate procedures.

The Attorney General is required to act on the rule within 60 days. If approved, the Attorney

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[1] A.R.S. § 41-1057(2) provides: ". . . this article does not apply to . . . (2) the corporation commission, which shall adopt substantially similar rule review procedures, including the preparation of an economic impact statement and the statement of the effect of the rule on small business."

General shall file the rule package with the Secretary of State. If disapproved, the Attorney General shall return the rules, together with the reasons for disapproval, to the agency. A.R.S. § 41-1044(C), (D).

In the explanatory statement accompanying Decision No. 59943, the Commission's Staff ("Staff") argued that the rules are not subject to Attorney General "certification," on grounds that the rules are "a manifestation of the Commission's ratemaking authority." *Id.* at 37. In support of its claim, Staff cites *Ariz. Corp. Comm'n v. Woods*, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992), and *Corbin v. Ariz. Corp. Comm'n*, 174 216, 219, 848 P.2d 301 (Ariz. App. 1992). This argument misses the point. First, the cases cited by Staff construed a prior statue, A.R.S. § 41-1041, which was repealed in 1994. The newly-enacted statute requires the Attorney General to approve the rules in accordance with the statutory criteria, but does not require "certification." Second, Citizens does not allege that the rules exceed the Commission's regulatory authority, the issue addressed in *Woods* and *Corbin*, but rather that the rules have not been promulgated in accordance with the procedural requirements of the APA. The Commission should grant rehearing to remedy this procedural deficiency and to provide that the rules are promulgated in accordance with the requirements of the APA.

B. The Commission failed to provide for additional notice and comment following its substantial revisions to the rules as originally proposed

The rules are also invalid because the Commission failed to provide the additional notice and opportunity for comment required by statute in response to the substantial amendment to the provisions of the proposed rule affecting political subdivisions, municipalities and other electric utilities not subject to the Commission's jurisdiction. A.R.S. § 41-1025(A) provides that the Commission may not adopt a rule that is substantially different from the proposed rule contained in the notice of proposed rule adoption. Where amendments to the proposed rule are substantial, the amended rule must be published in the *Arizona Administrative Register* and the Commission must allow at least thirty days for

interested parties to file additional written comments.[2] A.R.S. §§ 41-1022(D); 41-1023(B); 41-1025(A). The amendments to the in-state reciprocity provisions reflected in the December 13, 1996 amended rules are plainly substantial, as discussed below, and require additional notice and comment. The Commission's failure to provide for additional notice and comment in accordance with the APA is clear error.

In the proposed rules issued October 10, 1996, the Commission acknowledged that its jurisdiction does not extend to Arizona political subdivisions and municipal corporations (non-jurisdictional utilities) and that it is without authority to require non-jurisdictional utilities to comply fully with the proposed rules. *See* Proposed Rules at A.A.C. R14-2-1611. As a result, the proposed rules provided that: (a) the service territories of non-jurisdictional utilities shall not be open to competition and such utilities may not compete for sales in Affected Utilities' service territories, (b) jurisdictional utilities that are not Affected Utilities may participate voluntarily in the competitive market if they open their own service territories to competition and obtain a Certificate of Convenience and Necessity ("CC&N"), and (c) non-jurisdictional utilities may participate voluntarily in the competitive market if they open their own service territories to competition, agree to all of the requirements of the proposed rules (other than the requirement that they obtain a CC&N), if adequate enforcement mechanisms can be established, and if all Affected Utilities consent in writing. In addition, the proposed rules stated that the Commission will examine the need for additional legislation to address the role of non-jurisdictional utilities in a competitive market. Proposed Rules at A.A.C. R14-2-1611(D).

In stark contrast to this approach, the amended rules issued December 13, 1996

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[2] While the governing statute does not specifically define "substantial," it lists the following factors to be considered in determining whether amendments to a proposed rule require that the rule be subject to additional notice and comment: (1) the extent to which all persons affected by the adopted rule should have understood that the published proposed rule would affect their interests; (2) the extent to which the subject matter of the adopted rule or the issues determined by that rule are different from the subject matter or issues involved in the published proposed rule; and (3) the extent to which the effects of the adopted rule differ from the effects of the published proposed rule if it had been adopted instead. A.R.S. § 41-1025(B).

provided that a non-jurisdictional utility is required merely to file a statement with the Commission indicating that it will open its service territory to competing sellers "in a manner similar to the provisions of this Article," rather than under the specific provisions of the Commission's rules. Further, the amended rules abandoned the prior provision requiring that adequate enforcement mechanisms be established, substituting instead language incorporating by reference certain of the Commission's procedural rules for acting upon complaints. Moreover, the amended rules eliminated the previous requirement that Affected Utilities consent to the specific mechanisms to be used to extend the proposals for restructured services to include non-jurisdictional utilities. The amended rules also included a new section which states that if the non-jurisdictional utility is an Arizona political subdivision or a municipal corporation, the existing service territory for that utility shall be deemed open to competition if the utility has entered into an intergovernmental agreement with the Commission. Decision No. 59943 adopted the amended rules without further revision.

The changes to the proposed rules have sweeping impact on every aspect of the rules and upon the most basic questions of the scope of the Commission's jurisdiction and the matter of how -- and upon which utilities -- the proposed rule may be applied. In Arizona, non-jurisdictional utilities account for a substantial share of the potential market for retail competition and the scope of the Commission's jurisdiction and the legal bases for the imposition of the amended rules upon non-jurisdictional utilities have been highly contentious issues involving complex legal and policy issues. Previously, the Commission correctly acknowledged that it had been unable to resolve many of the questions concerning the application of the proposed rule to non-jurisdictional utilities and that legislation might well be required to resolve fully these difficult legal and policy issues.[3] As a result, the Commission's abrupt resolution of these issues is a substantial and dramatic change from

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[3] *See, e.g.,* Staff's Memorandum accompanying Staff's Proposed Rule on Electric Industry Restructuring at 4 (October 1, 1996); Transcript of Commission October 8, 1996 Special Open Meeting at 44-54.

the proposed rules which mandates additional public comment. The Commission's failure to provide for additional notice and comment in response to the substantial changes to the rule as originally proposed is erroneous and the Commission should grant rehearing to provide for the full measure of public participation required by the APA.

C. The Commission failed to adequately address parties' comments.

The rules are also invalid because the Commission failed to adequately consider interested parties' comments. A.R.S. § 41-1024(c) specifies that "[b]efore the adoption of a rule, an agency shall consider the written submissions, the oral submissions or any memorandum summarizing the oral submissions, the economic, small business and consumer impact statement." Further, A.R.S. § 41-1036 requires that the Commission, at the time it adopts a rule, issue a concise explanatory statement containing: (1) an indication of any change between the text of the proposed rule contained in the notice of proposed rule adoption and the text of the rule as finally adopted, with the reasons for any change, and (2) an evaluation of the arguments for and against the rule, including a response to comments received on the proposed rule and any supplemental notices. The statute also specifies that only the reasons contained in the concise explanatory statement or the preamble may be used by any party as justifications for the adoption of the rule in any proceeding in which its validity is at issue.

The explanatory statement accompanying the rules adopted in Decision No. 59943 falls far short of the statutory standard requiring that the Commission "evaluat[e] . . . the arguments for and against the rule, including a response to comments received on the proposed rule." Instead, the Commission's explanatory statement is little more than a selective restatement of the reply comments of Staff, and is wholly lacking the independent "evaluation" called for by the governing statute. This failure to adequately consider and evaluate the comments submitted in response to the proposed rule invalidates the rules adopted by Decision No. 59943. The Commission should grant rehearing to address in sufficient detail the comments of all interested parties concerning the rules that will govern the transition to a more competitive market for electric services.

III. THE RULES ARE PROCEDURALLY INVALID BECAUSE THEY ARE IMPERMISSIBLY VAGUE AND VIOLATE DUE PROCESS

The rules adopted by the Commission are designed to facilitate a dramatic and far-reaching change in the structure and operation of the electric utility industry, moving Affected Utilities toward a competitive market for energy services. To this end, the rules prescribe a time line for the implementation of retail competition, requiring Affected Utilities to make available all of their retail demand for competitive generation supply not later than January 1, 2003. Yet the rules pursuant to which the Commission will accomplish this profound regulatory change are themselves nothing more than a "skeletal framework" which defers resolution of a host of essential issues and which fails to provide sufficient detail to enable Affected Utilities to conform to the rule. This lack of clarity and definition is contrary to basic principles of due process and fails to provide the reasoned basis and evidentiary support essential for any agency action to be sustainable.

A. The rules defer resolution of essential issues and fail to provide sufficient detail of their regulatory requirements

A critical flaw in rules is the fact that they are, in many important respects, a work in progress. The Commission itself characterized the proposed rules as merely a "framework" for the transition to a more competitive marketplace for the electric utility industry.[4] As a result, while the rules establish a binding time line for the implementation of retail competition, the rules will also be subject to further review and modification, creating a process whereby many of the specific requirements necessary for Affected Utilities to comply with the rules will not be known for some time.

It is undisputed that the rules do not resolve several key issues, including system reliability and safety, the treatment of stranded costs, the method for determining customer access to the competitive market prior to January 1, 2003, the features of unbundled and Standard Offer Service, the method for calculating System Benefits Charges, and undefined

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[4] *See, e.g.*, Transcript of Commission October 8, 1996 Special Open Meeting at 4, 5, 14,16, 126; Concurring opinion of Commissioner Carl J. Kunasek (October 9, 1996).

"legal issues." Instead, these subjects are to be addressed by "Working Groups" to be created in accordance with specific provisions of the rules. These working groups will examine each of these areas in greater detail and make recommendations to the Commission. Such recommendations appear to be non-binding, and it is not clear from the rules what action, if any, the Commission is required to take in response to the working groups' reports.

The issues assigned to these working groups touch on all aspects of the transition to a competitive market for energy services. With regard to stranded costs, the working group is charged with developing recommendations concerning all aspects of "the analysis and recovery of stranded costs." Similarly, essential determinations governing the rates for both unbundled and standard offer service will be addressed in a series of workshops, which will consider such matters as designation of appropriate test years, adjustments to test year data, metering requirements and protocols, and service characteristics, including voltage levels. Further, while the rules establish a System Benefits Charge, the method to be used to calculate this charge is to be determined in a future workshop.[5]

By assigning these matters to a working group, the Commission has reserved the right to subsequently change virtually every aspect of the rules' stranded cost provisions in response to the working group's recommendations. While further study is plainly required to address many of the difficult questions presented by the move to a more competitive market, Affected Utilities cannot begin this transformation when key components of the rules mandating that change may themselves be changed at any time. The rules' requirements must be known with certainty before utilities can make long-range decisions concerning the

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[5] The use of working groups to resolve many of the complicated and contentious issues underscores the absence of finality and predictability of the rules. For example, with regard to stranded costs, the working group is directed "to develop recommendations for the analysis and recovery of Stranded Costs." A.A.C. R14-2-1607(C). In preparing its recommendations, the working group is to consider the same factors to be considered by the Commission when determining the amount and recovery mechanism for individual utilities' proposals for stranded cost recovery. A.A.C. R14-2-1607(D).

utilization of existing facilities, stranded cost mitigation, and the nature of the new services to be offered in a competitive market.[6] As adopted, the rules fail to provide a reasonable level of detail and certainty concerning the standards that Affected Utilities will ultimately be required to meet.

B. The failure of the rules to provide detail sufficient for Affected Utilities to conform their conduct to the rules violates due process

Fundamental principles of due process reflected in the Fourteenth Amendment to the United States Constitution and Article 2, Section 4, of the Arizona Constitution require that regulatory mandates be articulated with reasonable precision and that they not be so vague or ambiguous that a reader "of common intelligence must necessarily guess at their meaning and differ as to their application." *Cohen v. State*, 121 Ariz, 6, 9, 588 P.2d 299, 302 (Ariz. 1977). *See Cavco Industries v. Industrial Comm'n of Arizona,* 129 Ariz.429, 434, 631 P.2d 1087, 1092 (Ariz. 1981); *State v. Cota*, 99 Ariz. 233, 236-37, 408 P.2d 23, 26 (Ariz. 1965); *Southwest Engineering Co. v. Ernst*, 79 Ariz. 403,412-13, 291 P.2d 764, 770-71 (Ariz. 1955). In *State Compensation Fund v. De La Fuente,* 18 Ariz. App. 246, 501 P.2d 422 (Ariz. App. 1972), the court explained:

> An act must be complete in all its terms when it leaves the legislature; so that those charged with the administration of such act are amenable to the courts for failure to put it into effect or for its maladministration, and so that everyone may know by reading the law what his rights are and how it shall operate when put into execution; and the court cannot supply material and essential omissions.

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[6] Apart from the matters assigned to working groups, many other aspects of the rules are vague and ambiguous. For example, A.A.C. R14-2-1603 requires Electric Service Providers intending to offer jurisdictional "Competitive Services" to obtain a CC&N, except to the extent that service is to be provided within the utility's distribution service territory. Yet the rules do not identify or explain parties' competing rights under new or existing CC&Ns, or how the historic CC&N approach is to be applied in a market open to retail competition. Moreover, the rules provide no guidance to assist Affected Utilities to define or maintain the boundaries between competitive and regulated services and customers. Further, A.A.C. R14-2-1607(A) directs Affected Utilities to mitigate stranded costs, but provides no guidance concerning the specific mechanisms to be used or the extent to which related costs may be recovered through rates. Finally, the rules contain only the most skeletal framework with regard to its application to political subdivisions or municipal corporations. *See* A.A.C. R14-2-1611.

Id. at 251-52 (quoting 82 C.J.S. Statutes § 64 (1953)). This principle applies with equal force to regulations promulgated by the Commission. As the Supreme Court explained in *Securities and Exchange Commission v. Chenery*, 332 U.S. 194 (1947), "[i]t will not do for a court to be compelled to guess at the theory underlying an agency's action; nor can a court be expected to chisel that which must be precise from what the agency has left vague and indecisive. In other words, 'We must know what a decision means before the duty becomes ours to say whether it is right or wrong.'" *Id.* at 196-97 (quoting *United States v. Chicago, M., St. P & P.R. Co.*, 294 U.S. 499, 511 (1935)).

The rules adopted in Decision No. 59943 fail to meet this required level of detail and clarity and are therefore invalid. As noted above, the rules defer action on essential issues and are in many instances vague and ambiguous, such that neither an Affected Utility nor a reviewing court can determine the rules' specific regulatory requirements. As such, the rules fail to satisfy the minimum requirements for due process. It is not legally sufficient for the Commission to simply promulgate a framework and then compel Citizens and other Affected Utilities to restructure their business in conformity with an ill-defined rule that is subject to further change. Affected Utilities, Electric Service Providers and other participants in the market for energy services have the right to know how they will be regulated at the time the rule is adopted. The Commission should grant rehearing in order to amend the rules to comply with the fundamental requirements of due process.

C. The "process" provided for by the rules does not satisfy due process requirements

In the explanatory statement accompanying Decision No. 59943, the Staff states that because the rules "set up a process" for future consideration of stranded cost recovery, the rules create "an objective standard which the Commission must follow" and "give the utility an opportunity to know what the law is so it can plan ahead." (Explanatory Statement at 39.) Staff fails, however, to acknowledge that the rules do not contain the standards required to give this "process" the level of detail and predictability required by due process. For example, the rules assign to a working group the task of developing recommendations for the

analysis and recovery of stranded costs, identifying factors to be considered by the working group in preparing its recommendations. Once these recommendations are received by the Commission it is required only to consider them and may choose to take any action it elects with regard to stranded cost recovery. *See* A.A.C. R14-2-1607. While this aspect of the rules clearly "sets up a process," it cannot be claimed that this process specifies "an objective standard which the Commission must follow." (Explanatory Statement at 39.) The Staff cannot credibly claim that the procedural mechanism which provides for a forum, but which does not specify how or by what standard issues will be addressed in that forum, satisfies due process requirements. Accordingly, the Commission should grant rehearing in order to develop further these aspects of the rules consistent with the requirements of due process.

IV. THE RULES IMPROPERLY DEFER AS PREMATURE ISSUES CONCERNING STRANDED COSTS AND FAIL TO RECOGNIZE THAT AFFECTED UTILITIES SHOULD BE PROVIDED A REASONABLE OPPORTUNITY FOR STRANDED COST RECOVERY

In its comments concerning the proposed rules, Citizens established that utilities are entitled to a reasonable opportunity to recover fully their stranded costs and that disallowance of stranded cost recovery violates the regulatory compact and may amount to an unconstitutional taking. In the explanatory statement accompanying Decision No. 59943, Staff argues that despite the long-standing regulatory regime governing Arizona utilities, "no such contract has been formed," and dismisses as premature commenters' claims that denying utilities a reasonable opportunity for stranded cost recovery is a taking. Citizens' prior comments also demonstrated that the Commission is without legal authority to bar recovery through rates of the costs of power purchase contracts. Decision No. 59943 does not address this concern.

The Commission's failure to address at this time the substantive issues concerning stranded cost recovery is clear error and the Commission should grant rehearing of Decision No. 59943 to provide for further consideration of these critical issues. As the following discussion will show, the legal analysis accompanying the rules is flawed and fails to address several aspect of Citizens' prior comments.

A. The Commission's Disavowal of the Regulatory Compact is Erroneous and Reflects an Unreasonable Attempt by the Commission to Avoid the Consequences of the Implementation of the Rules

In Decision No. 59943, the Commission recognized that stranded costs arise from the profound regulatory changes required to move the electric utility industry from a system of regulated monopolies to a more competitive market, and that utilities should be allowed to recover costs incurred in reliance on the continuation of the previous regulatory system. This opportunity for stranded cost recovery arises from the fact that Arizona utilities, like utilities throughout the United States, are charged with the obligation to serve all customers within a defined service area and are restricted in the amount they may charge for their service to rates that allow for a reasonable return on and of utility investments made in order to meet the obligation to serve. This obligation to serve coupled with a right to a reasonable return comprises the regulatory compact that is at the heart of government regulation of public utilities. As Judge (now Justice) Scalia has explained, "the very nature of government rate regulation" is "a compact whereby the utility surrenders its freedom to charge what the market will bear in exchange for the state's assurance of adequate profits." *New England Coalition on Nuclear Pollution v. Nuclear Regulatory Comm'n*, 727 F.2d 1127, 1130 (D.C. Cir. 1984). *See Application of Trico Electric Co-operative, Inc.*, 92 Ariz. 373, 380-81, 377 P.2d 309, 314-15 (Ariz. 1962).

Under Arizona law, utilities are required to provide safe and adequate service. A.R.S. § 40-321(A) provides:

> When the commission finds that the equipment, appliances, facilities or service of any public service corporation, or the methods of manufacture, distribution, transmission, storage or supply employed by it are unjust, unreasonable, unsafe, improper, inadequate, or insufficient, the commission shall determine what is just, reasonable, safe, proper, adequate or sufficient and shall enforce its determination by order or regulation.

A.R.S. § 40-361(B) similarly provides:

> Every public service corporation shall furnish and maintain such service, equipment and facilities as will promote the safety, health, comfort, and convenience of its patrons, employees and the public, and as will be in all respects adequate, efficient and reasonable.

Utilities are also obligated to supply electricity as a public service to all customers that

require it, and, as part of this regulatory compact, the State agrees to provide the utility with the exclusive right to serve all customers within a defined territory. In *Application of Trico Electric Co-operative, Inc.*, 92 Ariz. 373, 377 P.2d 309 (Ariz. 1962), the Arizona Supreme Court explained:

> In the performance of its duties with respect to public service corporations the Commission acts as an agency of the State. By the issuance of a certificate of convenience and necessity to a public service corporation the State in effect contracts that if the certificate holder will make adequate investments and render competent and adequate service, he may have the privilege of a monopoly as against any other private utility.

Id. at 380-81.

This obligation to serve exists in tandem with the utilities' right to charge rates that permit recovery of the costs of service and a reasonable rate of return. A.R.S. §40-361(A) states this principle clearly:

> Charges demanded or received by a public service corporation for any commodity or service shall be just and reasonable. Every unjust or unreasonable charge demanded or received is prohibited and unlawful.

See also Ariz. Const. at Article 15, Section 3 (enumerating powers of Commission). The courts have consistently held that just and reasonable rates shall provide utilities with the opportunity to recover their costs and to earn a return on their investment. *See, e.g., Duquense Light Co. v. Barasch*, 488 U.S. 299, 307, 314 (1989); *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of W. Virginia*, 262 U.S. 679, 692-93 (1923); *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (Ariz.1956); *Scates v. Arizona Corporation Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (Ariz. App. 1978).

The rules violate this regulatory compact to the extent that they put utilities at risk to under recover stranded costs. In reliance on the continuing obligation to serve, Citizens, like other utilities, made investments in physical assets and entered into long-term contracts with wholesale power suppliers in order to continue to meet its public service obligations. Investors were willing to underwrite these long-term investments in reliance upon the existing regulatory regime which provided Citizens the ability to recover its costs, and earn a

reasonable return on its investment, through the collection of Commission-prescribed just and reasonable rates. A change in regulatory policy that has the effect of preventing Citizens from recovering the costs it incurred in reliance on the continuation of the pre-existing regulatory policy would violate this long-standing regulatory compact.

In recognition of the investments made by public utilities in reliance upon the continuation of the regulatory compact, abrupt changes in regulatory policy have been found to violate the regulatory compact in a manner that requires that the affected entity be compensated for its resulting injury. In *United States v. Winstar Corp.*, 116 S. Ct. 2432 (1996), the Supreme Court held that the government was responsible financially to a regulated business for the economic injury that resulted from a change in regulatory policy. The decision in *Winstar* concerned the impact of changes in federal legislation governing the accounting treatment for so-called "regulatory goodwill," which had the effect of reducing the book value of institutions that had acquired ailing thrift institutions in reliance on the prior policy to a level rendering many of them insolvent or in violation of regulatory capital requirements. The Court examined the nature of the relationship between the regulated entities and the regulatory authority and concluded:

> [I]t would have been irrational in this case for [the institution] to stake its very existence upon continuation of current policies without seeking to embody those policies in some sort of contractual commitment. This conclusion is obvious from both the dollar amounts at stake and the regulators' proven propensity to make changes in the relevant requirements. . . . Under the circumstances, we have no doubt that the parties intended to settle regulatory treatment of these transactions as a condition of their agreement. *See, e.g., The Binghamton Bridge*, 3 Wall. 51, 78 (1866) (refusing to construe charter in such a way that it would have been 'madness' for private party to enter into it).

Id. at 2449; *see also id.* at 2472 ("It would, indeed, have been madness for [the institutions that acquired the thrifts] to have engaged in these transactions with no more protection than the Government's reading would have given them, for the very existence of their institutions would have been in jeopardy from the moment their agreements were signed") (plurality opinion).[7]

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[7] This result is unaffected by the fact that the regulatory compact derives from long-established regulatory policies and practices rather than from specific

Utilities made facilities investments and entered into long-term power purchase contracts based on the regulatory assurance that their prudent investments would be recoverable through rates. *Detroit v. Detroit Citizens' Street Railway Co.*, 184 U.S. 368, 385 (1902) ("It would hardly be credible that capitalists about to invest money in what was then a somewhat uncertain venture, . . . would at the same time . . . give the right to the [government] to change at its pleasure from time to time those important and fundamental rights affecting the very existence and financial success of the company"). Moreover, because of the continuing obligation to serve and the long-range planning required for utilities to ensure adequate supplies to meet their public service obligations, utilities cannot readily retrade power purchase contracts or investments in generation assets in response to abrupt shifts in regulatory policy. Having ordered or sanctioned substantial investments by utilities upon the understanding that such investments would be recoverable through rates, it is clear error for the Commission to repudiate its obligation to provide the utilities a reasonable opportunity to recoup such investments and/or contractual commitments.

In the explanatory statement accompanying Decision No. 59943, Staff contends that no regulatory compact exists. This argument is ill-founded and should be rejected. Simply put, Staff argues that absent a clear indication that the legislature intends to be bound there is no regulatory compact, citing *National Railroad Passenger Corp. v. Atchison, Topeka and Santa Fe Railroad Co.*, 470 U.S. 451 (1985) (Explanatory Statement at 35-36.). This argument misses the point. In *National Railroad*, a group of railroads challenged on due process grounds an amendment to the Rail Passenger Service Act which required the railroads to reimburse Amtrak for the cost of certain passenger services, contending that the

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contracts. The Commission's obligation to honor its regulatory commitments is derived from the relationship between the regulatory authority and the regulated entity and is not grounded on a specific instrument or contractual commitment. *See, e.g., Winstar*, 116 S. Ct at 2452 (agreement to provide particular regulatory treatment "are especially appropriate in the world of regulated industries, where the risk that legal change will prevent the bargained-for performance is always lurking in the shadows"). Justice Scalia, in his concurring opinion, stated this point even more directly: a "promise to accord favorable regulatory treatment must be understood as (unsurprisingly) a *promise* to accord favorable regulatory treatment." *Id.* at 2477 (emphasis in original).

Act constituted a binding contract between the United States and the railroads and that the amendment therefore impaired an obligation of the United States under that contract. In that case, the Supreme Court held that the Act did not constitute a contract and denied the railroads' claim. Unlike *National Railroad*, Citizens does not assert that the Commission is barred by a regulatory compact from implementing the amended rule. Rather, the Company's position is simply that it should be provided a reasonable opportunity to recover stranded costs that result from Commission actions that change the existing regulatory regime and that denial of that opportunity violates the regulatory compact.

As Citizens has clearly shown, in recognition of the long-term investments made by public utilities in reliance upon the continuation of the regulatory compact, abrupt changes in regulatory policy violate the regulatory compact in a manner that requires that the affected entity be compensated for its resulting injury. Having ordered or sanctioned substantial investments by utilities upon the understanding that such investments would be recoverable through rates, the Commission may not now repudiate its obligation to provide the utilities a reasonable opportunity to recoup such investments and/or contractual commitments. Accordingly, the Commission should grant rehearing to reconsider its conclusions concerning the validity of the regulatory compact and the remedies for Affected Utilities where regulatory change undermines that compact.

B. The Commission Improperly Dismissed as Premature Claims Addressing the Standards to be Applied for Stranded Cost Recovery

In is well established that property rights of regulated utilities enjoy constitutional protection. *Atlantic Coast Line R.R. v. North Carolina Corp. Comm'n*, 206 U.S. 1, 20 (1907). The Takings Clause in the Fifth Amendment specifies that the government cannot "'forc[e] some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.'" *Dolan v. City of Tigard*, 114 S. Ct. 2309, 2316 (1994) (quoting *Armstrong v. United States*, 364 U.S. 40, 49 (1960)). As a result, a Commission order denying Citizens' ability to recover its stranded costs would constitute an uncompensated taking of private property in violation of the Fifth Amendment and Article II, Sections 4, 17

of the Arizona Constitution.

Decision No. 59943 deflects the arguments concerning stranded cost recovery by asserting that such arguments are "premature." This approach is clearly erroneous. According to Staff, the rules merely set forth a process to allow for future requests for stranded cost recovery, and are not determinative of parties' rights. *See* Explanatory Statement at 40-41. As detailed below, the legal bases for stranded cost recovery are well-established. The Commission should grant rehearing and should revise its rules to address fully the standard to be applied to claims for stranded cost recovery.

The implementation of retail access without a reasonable opportunity for full stranded cost recovery will constitute an unconstitutional regulatory taking. The phase-in of full retail electric competition beginning in 1999 will require utilities to make available progressively greater portions of their transmission and distribution systems to customers that will acquire supplies from competing generation sources. This increased access to utility transmission and distribution systems will increase the likelihood of stranded investment, as utility-owned supply is displaced by competing suppliers.[8] Absent a reasonable opportunity for full recovery of associated stranded costs, this mandated unbundling of utility systems constitutes an unconstitutional taking.

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[8] This mandatory third-party access to utility systems also constitutes a physical occupation of utility property which may constitute a taking. In *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), the Supreme Court, addressing a city ordinance authorizing cable television companies to install cable on private buildings, held that the physical presence of the cable on the owner's property was a taking that required compensation. *Id.* at 426 (a "permanent physical occupation is a taking without regard to the public interests that it may serve"). The unbundling of utilities' transmission and distribution system is a similar physical occupation of private property in that competing energy suppliers are provided access to utilities' lines. *Cf. Florida Power Comm'n v. Florida Power & Light Co.*, 404 U.S. 453, 455-57 (1972) (noting that the transmission of electricity is a physical process). Moreover, it is not necessary for the physical occupation to be continuous for a taking to occur, only that the right to access be permanent. *See Nollan v. California Coastal Comm'n,* 483 U.S. 825, 832 (1987) ("a 'permanent physical occupation' has occurred, for purposes of [the *Loretto*] rule, where individuals are given a permanent and continuous right to pass to and fro, so that the . . . property may continuously be traversed, even though no particular individual is permitted to station himself permanently upon the premises").

In *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978), the Supreme Court, applying precedent dating back to *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922), explained that government decisions that interfere with a property interest constitute a taking under the Fifth Amendment. *Penn Central* set out three factors to be considered to determine whether regulation "goes too far" and constitutes a taking: (a) the character of the government action, (b) the economic impact of the regulation, and (c) the extent to which the regulation interferes with investment-backed expectations. When these factors are applied to the present case, it is clear that any disallowance of stranded costs would constitute a taking.

First, the character of the government action, the pervasive regulatory changes designed to transform the electric utility industry from a system of regulated monopolies to a competitive market, should not override utility investors' interest in continuing recovery of costs incurred in order to meet the utilities' public service obligations. This factor requires a balancing of the purpose and importance of the regulatory imposition with the competing private property interests. *Loveladies Harbor, Inc. v. United States*, 28 F.3d 1171, 1176 (Fed. Cir. 1994). This analysis also looks to whether the means selected for obtaining the regulatory goal were reasonably designed to attain it. *Id.* In the present case, the failure to allow for full recovery of stranded costs does not bear a reasonable relation to the state's interest in promoting competition for energy services. The costs that would be rendered stranded as a result of the regulatory changes imposed by the Commission are costs that were incurred by Citizens as part of its public service obligations. There is no reasonable basis for concluding that the Commission's decision to promote competition requires the disallowance of costs incurred to provide service at rates previously held to be just and reasonable.

Second, the economic impact of this potential under recovery of costs is substantial. While there is at present no single, widely-accepted estimate of utilities' stranded cost exposure, estimates run into the hundreds of millions -- if not billions -- of dollars. These costs represent utilities' prudent investments, undertaken to serve the public and approved

for inclusion in just and reasonable rates. Accordingly, while various parties may disagree as to the level of such stranded costs, there can be no doubt that the utilities have met the "threshold requirement that [they] show a serious financial loss from the regulatory imposition." *Loveladies Harbor*, 28 F.3d at 1177.

Third, it is beyond dispute that the disallowance of stranded cost recovery interferes with utility investors' reasonable investment-backed expectations. Citizens and other Affected Utilities invested in physical assets, entered into power purchase contracts, and created regulatory assets pursuant to regulatory approvals and with the reasonable expectation that these costs would be recovered through future rates. Any disallowance of these costs will impair the investors' expectation of recovery of -- and of a return on -- these investments.[9] Any denial of an opportunity to recovery these costs constitutes a governmental taking. As Justice Brandies explained, in *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Comm'n*, 262 U.S. 276 (1923):

> The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of capital, whatever the nature of the security issued therefore; the allowance for risk incurred; and enough more to attract capital.

Id. at 291 (Brandies, J., concurring). The Commission's failure to allow for full stranded cost recovery plainly impairs these reasonable, investment-backed expectations.

When the *Penn Central* factors are considered together, it is clear that to the extent that the Commission mandates retail competition yet disallows an Affected Utility's full recovery of its stranded costs, any such under recovery will constitute an impermissible regulatory taking of the utilities' property.

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[9] Debt and equity securities issued by a public utility are investments in the same manner as comparable securities issued by any other business. *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."). As a result, if the return to utility investors falls below the return available from other investments with equivalent risks, investors will shift their capital to earn the greater return.

The implementation of retail access without a reasonable opportunity for full stranded cost recovery will additionally result in confiscatory rates. It is well-established that the Constitution both provides utilities with the right to a reasonable opportunity to recover -- and earn a reasonable return upon -- their prudent investments and prohibits state regulators from establishing rates at a level that would be confiscatory. *See, e.g., Duquense Light Co. v. Barasch*, 488 U.S. 299, 307, 314 (1989). This precedent also holds that just and reasonable rates fall within a range of permissible rates which balances investor and ratepayer interests. *See, e.g., In re Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942). Rates which fall below a just and reasonable level are confiscatory and in violation of the Takings Clause of the Fifth and Fourteenth Amendments. *See, e.g., Duquense, supra*, at 307-8 (rate is confiscatory where it is "so unjust as to destroy the value of [the utility] property for all the purposes for which it was acquired.") (citing *Covington & Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578, 597 (1896)).

More than half a century ago, the Supreme Court, in *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of W. Virginia*, 262 U.S. 679 (1923), described the protections guaranteed to utilities (and utility investors):

> The [allowed rate of] return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Id. at 692-93.

The Court elaborated on the standard to be applied to provide the constitutional protection of investor interests in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944):

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the service on the debt and dividends on the stock. . . . By that standard the return to the equity owner . . . should be sufficient to

> assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Id. at 603.

In Arizona, the Commission is charged with establishing just and reasonable rates, and in so doing must apply the general principle that the revenues derived from such rates "be sufficient to meet a utility's operating costs and to give the utility and its stockholders a reasonable rate of return on the utility's investment." *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (Ariz. 1956); *Scates v. Arizona Corporation Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (Ariz. App. 1978). The starting point for a determination of just and reasonable rates is the assessment of the fair value of the utility's property, which is used as the utility's rate base. Ariz. Const. Art. 15. The Commission must then apply a fair value rate of return to this rate base to set a just and reasonable rate. *Arizona Corporation Comm'n v. Arizona Public Service Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (Ariz. 1976).

The implementation of the rules without a reasonable opportunity to recover fully the stranded costs that flow from the move to a more competitive marketplace for energy services will put utilities at risk for under recovery of their costs of service and would deny utilities the ability to earn a return on their investment. The adoption of rates that would fall short of these constitutional requirements would constitute the confiscation of the utilities' property.

Citizens' prior comments established that the implementation of retail access without a reasonable opportunity for full stranded cost recovery will constitute an unconstitutional regulatory taking. In the Explanatory Statement accompanying Decision No. 59943, Staff does not address the merits of Citizens' comments, and instead dismisses such concerns as premature and not determinative of parties' rights. (Explanatory Statement at 40-41.)

Staff's decision to side-step the legal bases for stranded cost recovery is clear error. Citizens' prior comments provided a detailed discussion of the legal and policy grounds that would govern claims for stranded cost recovery. These comments demonstrated that the

implementation of the proposed rules without a reasonable opportunity to recover fully the stranded costs that flow from the move to a more competitive marketplace for energy services will put utilities at risk for under recovery of their costs of service and would deny utilities the ability to earn a return on their investment. These comments also established that the adoption of rates that would fall short of these constitutional requirements would constitute the confiscation of the utilities' property. To the extent that the Commission failed to address these concerns in Decision No. 59943, it has failed to fully "evaluat[e] . . . the arguments for and against the rule, including a response to comments received on the proposed rule" thereby invalidating the amended rule.

Further, Staff's claim that the rules do not prescribe a standard to be applied with regard to stranded cost recovery cannot be reconciled with Staff's prior claim, in response to commenters' due process challenges, that the rules "set forth an objective standard which the Commission must follow [in determining a utility's stranded cost]." (Explanatory Statement at 39.) Staff cannot have it both ways; either the rules do not promulgate a standard, in which case the Staff's response to commenters' due process arguments is without merit, or the rules do establish a standard, which requires the Commission to respond to the specific comments addressing that standard. Plainly, Staff's existing position cannot be sustained. As a result, the Commission should grant rehearing to consider further arguments concerning stranded cost recovery and the standard to be applied to requests for stranded cost recovery.

C. The Commission Erroneously Failed to Address or Consider Citizens' Showing that State Regulatory Agencies May Not Bar Recovery Through Rates of the Costs of Wholesale Power Purchase Contracts Approved by the Federal Energy Regulatory Commission

As Citizens noted in its comments, a substantial portion of the electricity it supplies to customers is purchased at wholesale from a variety of suppliers. The rates paid by Citizens for this power are set by the Federal Energy Regulatory Commission ("FERC"), which has exclusive jurisdiction over wholesale sales under the Federal Power Act. Because the FERC-approved wholesale rates comprise a key component of Citizens' wholesale costs, the filed rate doctrine, discussed further below, prohibits the Commission from adopting retail rates

that prevent the full recovery of these costs. As a result, the filed rate doctrine will invalidate any approach to stranded cost recovery that leads to under recovery of these power purchase contract costs. Decision No. 59943 fails to address or consider Citizens' prior comments on this point. This omission is clear error and requires that the Commission grant rehearing of Decision No. 59943.

A substantial portion of Citizens' electric power is acquired under wholesale power purchase contracts priced at FERC-approved rates. Citizens has only limited generation assets and must rely primarily on purchased power contracts to meet its energy and capacity requirements. Indeed, Citizens currently generates less than one percent of its total electricity supplies and acquires the balance of its requirements through wholesale purchase contracts. Moreover, unlike utilities that have substantial generating assets, Citizens does not earn a return on its substantial investments in these power purchase contracts.

The wholesale power contracts to which Citizens is a party are subject to federal regulation and are priced at FERC-approved rates. *See, e.g., Federal Power Comm'n v. Southern California Edison Co.*, 376 U.S. 205, 210-12 (1964). As a result, state regulatory commissions have no jurisdiction over such sales or the rates paid by Citizens or other Affected Utilities that purchase power at wholesale in the interstate market. *See, e.g., State of Utah v. FERC*, 691 F.2d 444, 446-48 (10th Cir. 1982).

States may not prevent recovery through retail rates of FERC-approved wholesale costs. The filed rate doctrine provides that FERC has exclusive jurisdiction over wholesale rates and that the rates filed with or approved by the FERC may not be altered at the state level. This preemptive authority is derived from the Federal Power Act, which states that the FERC shall determine whether electric wholesale rates are just and reasonable, and from the Supremacy Clause, which invalidates all state laws that conflict or interfere with an act of Congress.[10] *See Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 963-64 (1986);

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[10] This preemptive effect is also given to administrative regulations promulgated pursuant to Congressional authorization. *Kentucky West Virginia Gas Co. v. Pennsylvania Public Utility Comm'n*, 837 F.2d 600, 605 (3rd Cir.)(*citing Capital Cities*

Arkansas Louisiana Gas Co. v. Hall, 453 U.S. 571, 581-82 (1981). The Supreme Court first established the filed rate doctrine in *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.,* 341 U.S. 246 (1951). In that case, petitioner alleged that the rates approved by the Federal Power Commission were unreasonably high due to allegedly fraudulent conduct by an interlocking directorship and asked a federal court to apply a different rate to award damages. The Court applied principles of primary jurisdiction to conclude that the rate filed with and approved by the Federal Power Commission is the only legitimate or reasonable rate and that a court is without jurisdiction to apply a different rate. *Id.* at 251-52. The Court refined this holding in *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571 (1981), to rely expressly on preemption grounds. There, a seller of natural gas urged a state court to utilize a contract rate that exceeded the filed rate to calculate damages. The Court held that a state court may not substitute its judgement for the FERC, and could not apply a rate other than the rates on file with or approved by the FERC. *Id.* at 581-82 .

In a decision that is highly instructive on this issue, *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986), the Supreme Court addressed the impact of FERC's wholesale rate determination on state ratemaking authority. In *Nantahala*, the Court held that state regulatory commissions must allow for full recovery through retail rates of costs incurred by the payment of FERC-approved wholesale rates. Under this holding, the preemptive effect attaches not only to wholesale rates, but to all other FERC decisions "affect[ing] those rates." *Id.* at 966-67. Applying *Nantahala*, courts have held that state commissions may not question or alter the wholesale rates determined by FERC and may not bar local distribution companies from passing such costs through to local ratepayers. *See, e.g., Mississippi Power & Light Co. v. Moore*, 487 U.S. 354, 372 (1988); *Kentucky West Virginia Gas Co. v. Pennsylvania Public Utility Comm'n*, 837 F.2d 600, 609, (3rd Cir.), *cert denied*, 488 U.S. 941 (1988).

The filed rate doctrine, which operates independently of the constitutional prohibitions

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Cable, Inc. v. Crisp, 467 U.S. 691 (1984)), *cert. denied*, 488 U.S. 941 (1988).

against uncompensated takings discussed above, requires the Commission to enable Citizens and other comparable Affected Utilities to continue to recover through retail rates the costs of wholesale power purchase contracts. As a result, any approach to stranded cost recovery that would deny Citizens' full recovery of these costs will be invalid.

As another point of error, the Commission failed to address or consider Citizens' comments concerning the impact of the filed rate doctrine on Citizens' potential recovery of its power purchase costs. This omission is clear; the explanatory statement accompanying the amended rule does not address this portion of Citizens' comments. This omission is significant because the application of the filed rate doctrine, which operates independently of the constitutional prohibitions against uncompensated takings discussed above, requires the Commission to enable Citizens and other comparable Affected Utilities to continue to recover through retail rates the costs of wholesale power purchase contracts. As a result, any approach to stranded cost recovery that would deny Citizens' full recovery of these wholesale power purchase contract costs will be invalid.

Moreover, as noted above, the Commission's failure to address Citizen's comments violates the APA. With regard to this aspect of Citizens' comments, the explanatory statement accompanying the rules fails to meet the statutory standards requiring that the Commission "evaluat[e] . . . the arguments for and against the rule, including a response to comments received on the proposed rule." This failure to adequately consider and evaluate the comments submitted in response to the proposed rules invalidates the rules adopted by Decision No. 59943. The Commission should grant rehearing to address Citizens' comments and to clarify that it may not limit Citizens' ability to recover through its rates the cost of its power purchase contracts.

V. THE COMMISSION ERRONEOUSLY FAILED TO ENSURE THAT REVENUES FROM COLLATERAL SERVICES ARE NOT IMPROPERLY ALLOCATED TO OFFSET STRANDED COSTS

A.A.C. R14-2-1607(A) of the rules states that "Affected Utilities shall take every feasible, cost-effective measure to mitigate or offset Stranded Costs by means such as expanding wholesale or retail markets, or offering a wider scope of services for profit, among

others." While Citizens agrees that utilities should act in a reasonable manner to mitigate stranded costs, there is a critical distinction between mitigation and the use of revenues from collateral services to reduce -- or "offset" -- the stranded costs for which a utility may seek recovery. This distinction is ignored by Decision No. 59943, which states that revenues from all sources, including non-energy-related activities, should be applied to reduce stranded costs. Explanatory Statement at 45-46. This aspect of the Commission's order fails to address the central component of Citizen's comments and is clearly erroneous. The Commission should grant rehearing and the rules should be revised to ensure that the revenues from services unrelated to the incurrence of stranded costs are not improperly diverted to offset recoverable stranded costs.

The concept of mitigation of damages is a basic principle of contract law, and is generally understood to mean that an injured party may not unreasonably fail to act, thereby allowing its damages to accumulate, and then seek to recover the damages that could have been avoided. *See, e.g.*, C. McCormick, Handbook on the Law of Damages § 33 at 127 (1935). Professor Corbin has explained:

> It is not infrequently said that it is the "duty" of the injured party to mitigate his damages so far as that can be done by reasonable effort on his part. Since there is no judicial penalty, however, for his failure to make this effort, it is not desirable to say that he is under a "duty[."] This recovery against the defendant will be exactly the same whether he makes the effort and mitigates his loss, or not; but if he fails to make the reasonable effort, with the result that his injury is greater than it would otherwise have been, he cannot recover judgment for the amount of his avoidable and unnecessary increase. The law does nothing to compensate him for the loss that he has helped to cause by not avoiding it.

A. Corbin, Corbin on Contracts § 1039 at 242-43 (1964). Thus, with regard to stranded costs, the application of a mitigation theory would deny a utility recovery of stranded costs where it could be shown that the costs could have been avoided but for the utility's unreasonable acts or omissions. Citizens concurs with the Commission that utilities should take all reasonable efforts to mitigate avoidable stranded costs.

The rules' reference to offset, however, would apply a very different approach. While mitigation is designed to encourage cost avoidance, offset is designed to reduce cost responsibility. The rules describe "expanding wholesale or retail markets" and "offering a

wider scope of services for profit" as potential sources of revenues to offset stranded costs. This portion of the rules appears to suggest that revenues derived from other aspects of Affected Utilities' operations, including aspects of that bear no direct relation to the incurrence of stranded costs, should be used to reduce the level of stranded costs that would otherwise be eligible for recovery.

With regard to stranded costs, offset is an inappropriate remedy. Offset is comparable to the remedies of recoupment and counterclaim, and, like such remedies, is based on the presence of opposing -- or offsetting -- claims between two parties. *See, e.g., W.J. Kroeger Co. v. Travelers Indem. Co.*, 112 Ariz. 285, 287-88, 541 P.2d 385, 387-88 (Ariz. 1975); *Egan-Ryan Mechanical Co. v. Cardon Meadows Development Corp.*, 169 Ariz. 161, 170-71, 818 P.2d 146, 156 (Ariz. App. 1990); *Morris v. Achen Construction Co., Inc.*, 155 Ariz. 507, 509-10, 747 P.2d 1206, 1208-09 (Ariz. App. 1986), *aff'd in part and rev'd in part on other grounds*, 155 Ariz. 512, 747 P.2d 1211 (Ariz. 1987). In this context, offset is used to reduce a prevailing party's award by the amount of a claim owed by it to the opposing party.[11] The responsibility for stranded costs, however, does not fit into this claim/counterclaim approach because utilities' stranded costs are the result of legal and regulatory changes, rather than conduct on the part of utilities or their customers that would give rise to offsetting claims by one against the other.

Further, both the doctrines of mitigation and offset distinguish collateral source payments, holding that payments from other sources, independent of and collateral to the breaching party, received by the injured party are not to be used to diminish the injured party's damages. *See, e.g., Folkstead v. Burlington Northern, Inc.*, 813 F.2d 1377, 1380-81 (9th Cir. 1987); *Russo v. Matson Navigation Co.*, 486 F.2d 1018, 1020 (9th Cir. 1973). For

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[11] For example, in *Morris v. Achen Construction Co., Inc.*, *supra*, a homeowner sued a contractor for breach of contract and other claims arising from an agreement between the parties for the construction of a home in the Echo Canyon area. The contractor filed a counterclaim for amounts due pursuant to the contract and other claims. The court applied the doctrine of recoupment to offset the award payable to the homeowner for the contractor's breach by the amount due the contractor under the contract.

example, where a seller of goods has multiple items, the damages from a breach of contract are not mitigated by other sales that would ordinarily occur in the normal course of business.

The prohibition on the use of collateral source revenues to reduce a party's damages will be essential in the restructured market for energy services. Many of the new services that may be offered by Affected Utilities will result from new investments in new markets and will have no bearing on the utility's recovery of its existing costs, including any stranded costs. These new investments will be made based on the opportunities available in the competitive market for such new services, one in which non-utility entrants will be competing with utilities for customers and investors solely on the basis of potential profits. The Commission should not unreasonably encumber these at-risk investments by mandating that the revenues derived from such new services be diverted to offset stranded costs.

Decision No. 59943 fails to address these concerns and simply restates Staff's prior position on mitigation. (Explanatory Statement at 45-46.) As noted above, Staff's failure to address or consider Citizens' comments violates the APA and invalidates the rules adopted by the Commission. Moreover, the use of incremental revenues as an offset to stranded costs may deny Affected Utilities a reasonable opportunity to recover their stranded costs. To the extent that collateral source revenues are used to reduce eligible stranded costs, utilities will be prevented from seeking recovery of such costs, which, in the absence of offset, could have been recovered. The Commission should grant rehearing to ensure that revenues derived from services unrelated to stranded costs are not improperly diverted to offset recoverable stranded costs.

VI. THE COMMISSION ERRED BY FAILING TO REVISE THE AMENDED RULES TO MAINTAIN A LEVEL PLAYING FIELD WITH REGARD TO AFFECTED UTILITIES AND UTILITIES NOT SUBJECT TO THE COMMISSION'S JURISDICTION

As discussed supra, the rules adopted in Decision No. 59943 are substantially different from the proposed rules with regard to the treatment of Arizona political subdivisions and municipal corporations and other Electric Service Providers that are outside the Commission's jurisdiction. These revisions to the proposed rules are substantial and require that the rules

be subject to additional notice and comment. In addition, the Commission should grant rehearing to clarify or revise aspects of the rules concerning non-jurisdictional utilities.

The revisions of the rules concerning in-state reciprocity present a host of new issues that warrant rehearing. For example, the proposed rules left for future determination the selection of viable enforcement mechanisms to be applied to non-jurisdictional utilities, and provided that such utilities would not be able to participate in the competitive market until such enforcement mechanisms had been adopted and agreed to by Affected Utilities. The rules ultimately adopted by the Commission abandon this approach, and permit non-jurisdictional utilities to participate in the competitive market without any provisions for enforcing the Commission's rules.[12] Decision No. 59943 does not explain the reasons for this change from the proposed rules.

Citizens urges the Commission to grant rehearing to reconsider this aspect of the rules adopted pursuant to Decision No. 59943. At present, the rules would open the door to non-jurisdictional utilities offering new services in a competitive market without any means of ensuring that such utilities comply with the same rules applicable to Affected Utilities. Citizens' overriding concern is that the Commission implement the move to competition in a manner that does not provide an unfair benefit to parties outside its jurisdiction, which may seek to take advantage of the benefits of a more competitive market without adhering fully to the obligations imposed by the rules. To this end, the Company supported the Commission's prior determination that a condition of any non-jurisdictional utility's ability to compete for sales in the service territory of an Affected Utility is the agreement by the non-jurisdictional utility to comply with all other applicable aspects of the rules and the

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[12] Indeed, it appears Commission Staff has not yet resolved whether the Commission or some other party has the authority to enforce the Commission's rules with respect to non-jurisdictional utilities. *See* Explanatory Statement at 53 ("there must be an objective party who can resolve disputes over whether electric service providers have fair, nondiscriminatory access to SRP's distribution system. If the Commission does not have the authority, some other party must take on this responsibility; other electric service providers may also want to be involved in the creation of this independent party.")

development of an appropriate enforcement mechanism. Only where there is such enforceable reciprocity will jurisdictional and non-jurisdictional utilities be able to compete on equal footing.

Further, the rules also revise substantially the specific regulatory requirements imposed on non-jurisdictional utilities. While the proposed rules required non-jurisdictional utilities to "agree to all the requirements of this Article other than any requirement to obtain a Certificate of Convenience and Necessity" as a condition of participation in the competitive market, the rules no longer apply the same rules to non-jurisdictional utilities. Rather, the rules now provide simply that non-jurisdictional utilities must only open their service territories to competing sellers "in a manner similar to the provisions of this Article" (emphasis added). The Staff offers no explanation for this move away from the requirements of the proposed rules for non-jurisdictional utilities. Moreover, Staff does not provide any guidance concerning the degree of similarity required for compliance with the rules. Citizens urges the Commission to grant rehearing to reconsider this aspect of Decision No. 59943.

Finally, the explanatory statement accompanying Decision No. 59943 fails to address several of Citizens' concerns regarding the need for a level playing field for jurisdictional and non-jurisdictional utilities. As a general response to certain legal issues, Staff argues that certain differences justify different treatment of Affected Utilities and other entities under the rules. (Explanatory Statement at 40.) This response does not address the following three aspects of the rules for which there is no apparent basis to support the different treatment of jurisdictional and non-jurisdictional utilities:

1. The rules require Affected Utilities to file Standard Offer Tariffs and unbundled service tariffs for service at cost-based rates, while stating that "market determined rates for competitively provided service from Electric Service Providers shall be deemed just and reasonable."

2. The rules require Affected Utilities to maintain accounting records in accordance with FERC uniform system of accounts while imposing no comparable requirement on Electric Service Providers.

3. The rules permit Electric Service Providers to file contracts that are not available to the public while imposing public filing requirements on comparable contracts entered into by Affected Utilities.

Citizens urges the Commission to grant rehearing of Decision No. 59943 and to revisit these provisions of the rules to ensure that the rules maintain a level playing field for all participants in the competitive market.

VII. CONCLUSION

Citizens continues to support the transition to a more competitive market for energy services. However, as detailed above, Citizens is concerned that the rules adopted pursuant to Decision No. 59943 are procedurally deficient and that Staff has failed to address in the rules many of the most important issues raised by the prior comments and by the transition to competition. Accordingly, Citizens urges the Commission to grant rehearing in this matter and to adopt the specific recommendations contained this Application for Rehearing.

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Respectfully submitted,

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